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A Tenacious Dollar . . .

Despite the steep plunge in U.S. domestic and eurodollar interest rates in recent weeks, the dollar has weakened only slightly in the foreign exchange markets. Since mid-July, the trade-weighted value of the dollar has declined by just about three per cent. In the same period, however, the U.S. discount rate has been trimmed four times—by two percentage points to ten per cent—while the Federal funds rate has dropped by more than four percentage points. Eurodollar rates have also plummeted. The three-month eurodollar rate has fallen by almost one-third since the end of June, from 16 per cent to under 11 per cent.

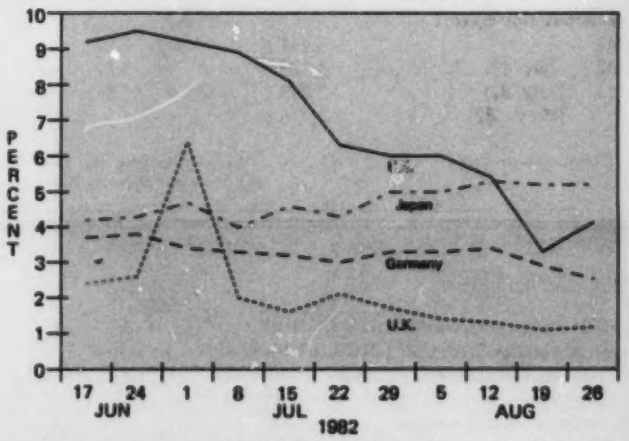
There has been a similar erosion in real (inflation adjusted) eurodollar interest rates. Since mid-July, for example, the real three-month eurodollar rate has plunged from 8.1 per cent to 4.1 per cent—a hefty decline of almost 50 per cent. Further, the positive interest rate spread which dollar-denominated financial assets have had over investments denominated in other currencies has diminished (see chart opposite). Last week, for example, the real three-month euroyen rate was 1.1 percentage points higher than the equivalent eurodollar rate. One month ago, the real euroyen rate was one percentage point lower than the equivalent eurodollar rate.

Until now, it has been the real interest rate advantage of dollar-denominated investments that has been given the primary credit for the resurgence of the dollar in the foreign exchange markets since the beginning of 1980. But this no longer appears to be as dominant a factor as it was even as recently as eight weeks ago. The divergent trends of real interest rates and dollar exchange rates are clearly emphasized by the fact that most of the principal foreign currencies hit their lowest levels in nearly three months against the dollar in mid-August, as U.S. domestic and eurodollar rates were dropping sharply.

. . . Resists Falling Interest Rates

But it would be premature to assume that the often close relationship between real interest rate spreads and the external value of the dollar has disappeared. Rather, it is more likely that the relative importance of other factors affecting exchange rates has increased. There has been a resurgence in the demand for prime-quality investments on the part of investors—domestic and foreign alike—which continues to make the best U.S. investments very attractive. Uncertainty in the Middle East, the much publicized difficulties of some major corporations and the soggy global economic environment have made investors particularly selective. Indeed, the drop in U.S. interest rates, the easing of U.S. monetary policy (Financial Digest— August 23, 1982), moderating inflation rates and passage of the $98.3 billion tax increase package all incline investors to view with increased confidence the near-term prospects for the U.S. economy. Thus, the continuing strength of the dollar appears to be more broadly based than a simple relationship between real interest rates and exchange rates.

REAL EUROCURRENCY INTEREST RATES



Monetary Policymakers Abroad . .

Of equal interest has been the reaction from abroad to falling U.S. interest rates. Until recently, a principal, if not universal, theme in the speeches of foreign statesmen and economists alike has been the restraining effects of high U.S. interest rates on the global economy. Yet, the sharp plunge in U.S. and

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eurodollar interest rates has not, so far, elicited matching reductions abroad. Although there was a flurry of central bank activity last week, uncertainty persists abroad about the duration of the present decline in U.S. interest rates. Consequently, foreign central banks' actions have been tentative, and slow in coming. The German central bank cut its Lombard rate by one per cent to eight per cent and the discount rate one-half per cent to seven per cent. Similar actions were taken by the Swiss, Dutch and Italian central banks. The Bank of England reduced its money market intervention rates in a series of steps totaling three-eighths of one percentage point, which is expected to lead to a cut in the base lending rate in the near future.

Other rates have also responded hesitantly to the decline in domestic U.S. interest rates and eurodollar rates. Although some three-month eurocurrency rates have eased slightly, none have approached the almost five percentage point eurodollar rate plunge. The three-month euromark rate, for example, has fallen by less than one per cent since mid-July. The euroyen rate was virtually unchanged last week from its position of one month ago. It is clear that despite widespread criticism of high U.S. interest rates, other countries are not yet prepared to reduce their interest rates substantially.

Over the past year, individual industrial countries

Selected Federal Reserve Data

(Averages of Daily Figures—Billions of Dollars)

Reserve Bank Credit	Week Ending 8/18/82	$ Change Since Week Ago	$ Change Since Year Ago
U.S. Gov'ts and Agencies Owned Outright & RPs	142.782	+ 1.877	+ 8.404
Loans to Depository Inst.	.483	+ .114	– .974
Float	1.866	– .504	– .873
Total Reserve Bank Credit	154.820	+ 1.026	+ 6.615
Treasury Deposits with Federal Reserve Banks	2.973	– .977	– .001
Currency Outside Banks	133.348	+ .988	+ 8.015
Member Bank Reserves:			
Required	40.326	+ 1.188	– .916
Excess (Deficiency)	.281	– .112	– .053
Total Reserves Held	40.607	+ 1.076	– .969
Net Borrowed Reserves	.071	+ .228	– .821
Gov'ts held for Foreign Acct. by F.R. Banks (End-of-Week)	95.158	– .863	+ 3.406

Monetary Aggregates†		% Change Since Three Months Ago*	% Change Since Year Ago
M1	454.9	+ 2.0$	+ 5.3$
M2 (July '82)	1,922.9	+ 9.0	+ 9.6
M3 (July '82)	2,319.8	+ 10.9	+ 10.3
L (March '82)	2,716.8	+ 11.2	+ 11.4

†Seasonally adjusted. *Seasonally adjusted annual rate. $Four-week moving average.

New York Money Market

Offering Rates 8/27/82	3 Months	6 Months	1 Year
$U.S. Treasury Bills	7.40%	9.10%	9.75%
* Federal Agencies	8.80	9.30	10.20
* Project Notes–Taxfree (46% Taxable Equivalent)	9.07	9.91	NA
Negotiable Time CDs Manufacturers Hanover	Rates By Arrangement		
* Secondary Market–Prime	10.40	11.40	11.75

$Finance Company Paper–Prime		$* Bankers' Acceptances	
5- 14 days	7.75%	Sep.	9.20%
15- 29 days	8.00	Oct.	9.50
30- 59 days	8.25	Nov.	9.80
60- 89 days	8.63	Dec.	10.00
90-179 days	9.00	Jan.	10.50
180-239 days	9.25	Feb.	10.50
240-270 days	9.25		

$Industrial Paper–Prime			
30- 89 days	8.75%	†Federal Funds Effective Rate	9.95%
90-120 days	9.25		

$Discount basis. * Subject to availability. † Estimated.

Selected Business Indicators

(All Dollar Figures in Billions)

	Latest Period or End of Period		Previous Period	Year Ago Period
Gross National Product (Current Dollars)*	2nd Q'82	$ 3,041	$ 2,998	$ 2,902
Gross National Product (1972 Dollars)*	2nd Q'82	$ 1,475	$ 1,471	$ 1,502
Percent Change, Annual Rate	2nd Q'82	1.3	– 5.1	– 1.5
Change in Consumer Prices (all urban consumers)*	Jul '82n	7.2%	12.0%	13.2%
Change in Producer Prices*	Jul '82	7.2%	12.0%	4.8%
Civilian Employment (Thousands of Persons)†	Jul '82	99,732	99,784	100,884
Unemployment as % of Civilian Labor Force†	Jul '82	9.8%	9.5%	7.2%
Personal Income	Jul '82	$2,592	$2,567	$2,436
Leading Indicators Composite Index (1967=100)†	Jun '82	127.9	127.9	135.2
Industrial Production Index (1967=100)†	Jul '82	138.1	136.2	153.9
Net Change in Consumer Installment Credit†	Jun '82	$ 1.35	$ 1.40	$ 2.03
U.S. Merchandise Trade Balance†	Jul '82n	–$ 2.42	–$ 3.44	–$ 1.78
Plant and Equipment Expenditures*	3rd Q'82	$328.04(a)	$336.77(a)	$328.25
Private Housing Starts (Thousands of Units)*	Jul '82	1,211	906	1,040
New Construction Expenditures*	Jun '82	$ 230.7	$ 227.7	$ 237.5
Total Business Inventories†	Jun '82	$ 512.0	$ 510.4	$ 501.4
Total Business Sales†	Jun '82	$ 344.5	$ 349.1	$ 356.3

*Seasonally adjusted annual rate. †Seasonally adjusted. n-Newly reported figure. a-Anticipated.

have sought to insulate their domestic financial markets from the influence of a restrictive U.S. monetary policy through selective interest rate cuts. Such attempts have often resulted in massive capital outflows and consequent depreciation of their currencies against the dollar, but without the expected improvement in employment and economic growth which the easier monetary policy was supposed to generate. Hence, they are reluctant to move precipitately at this time.

. . . Remain Cautious

Now, however, the sharp drop in U.S. interest rates presents foreign monetary policymakers with a range of alternative responses. On the one hand, maintaining interest rates at current levels as U.S. interest rates fall would, as real interest rate spreads turned in favor of the foreign country, lead to a reversal of the previous capital outflow. This, in turn, would result in a strengthening of that currency and a lowering of the cost of imports. Ultimately, if the capital inflows were sufficiently large, such a policy would lead to lower interest rates. The principal question is whether or not the other foreign countries have the time to let such a policy work in the present environment of low growth rates and high levels of unemployment.

On the other hand, an alternative monetary policy would be to allow interest rates to fall in tandem

Short Term Paper Outstanding

(Millions of Dollars)

	Latest Week	Change Since Week Ago	Change Since Year Ago
Negotiable Time CD's Weekly Reporting Banks			
Nationwide (8/11/82)	144,771	– 1,518	+17,744
New York City (8/11/82)	37,938	– 420	+ 7,478
Commercial Paper (8/11/82)	179,487	– 771	+26,977

Bank Loans

(Millions of Dollars)

Weekly Reporting Large Commercial Banks	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (8/11/82)	211,319	+ 371	+27,287
New York City (8/11/82)	59,292	– 120	+ 5,578

	Latest Week	Change Since Week Ago	Change Since Year Ago
Nationwide (8/11/82)	488,838	– 3,477	+41,587
New York City (8/11/82)	114,166	– 2,502	+ 7,268

Financial Markets

	Friday 8/27/82	Change Since Week Ago	Change Since Year Ago
U.S. Governments, Closing Yields:			
90-Day Bills†	8.12%	+ .87	– 7.88
180-Day Bills†	9.02	– .03	– 7.78
Longest Bills†	10.95	+ .85	– 5.80
Recent issues:			
11⅝s 8/31/84 (When Issued)	11.91	NA	
14⅞s 6/30/86	12.45	+ .40	
13¾s 5/15/92	12.71	+ .41	
14s 11/15/11	12.48	+ .30	
Municipals:			
Bond Buyer–20 Bond Index* (8/26/82)	10.38%	– .44	– 2.59
Blue List Total ($ Million)	$ 988	+ $243	+ $259
30-Day Visible Supply ($ Million)	$1,584	– $209	– $134
Total	$2,572	+ $ 34	+ $125
Corporates:			
Moody's Aa Composite (8/26/82)	13.94%	– .18	– 1.74
30-Day Visible Supply ($ Million) $	$ 870	– $255	NA
Stocks:			
Dow-Jones Averages:			
Industrials	883.47	+ 14.18	– 8.75
Transportation	349.82	+ 25.78	– 25.64
Utilities	114.25	– 1.11	+ 4.51
65 Stocks	343.46	+ 8.81	– 6.76
Standard and Poor's 500 Stocks	117.11	+ 4.09	– 6.97
N.Y.S.E. Composite Index	67.23	+ 2.58	– 4.74
N.Y.S.E. Avg. Daily Vol. for Week (000's)	110,080	+18,908	+ 65,356

* 46% Taxable equivalent 19.22%.
$ Series redefined: Historical data not available.
† Bond equivalent.

International Rates

EURODOLLAR DEPOSIT RATES (bid)	Friday 8/27/82	Week Ago
Overnight	9.63%	9.13%
1 month	10.00	9.88
3 month	10.31	10.31
6 month	12.00	11.25
1 year	12.38	12.06
EURODOLLAR BONDS		
Average Yield		
Medium Term (5 to 7 yrs.)	13.25%	13.35%
Long Term (7 to 15 yrs.)	13.50	13.60

FOREIGN EXCHANGE SPOT RATES New York Opening (8/27/82)	U.S. $ Equivalent	Currency Per U.S. $
Belgium	.02129	46.96
Canada	.8091	1.2360
Denmark	.1170	8.5495
France	.1453	6.8825
Germany	.4094	2.4485
Italy	.0007229	1383.30
Japan	.003923	254.90
Mexico	.007968	125.50
Netherlands	.3724	2.6850
Switzerland	.4817	2.0760
U.K.	1.7490	.5718

with U.S. interest rates, maintaining a consistent spread between the two countries' interest rates. The consequences of such a policy would be to continue the existing currency exchange rate, encourage domestic investment and stimulate the export sector as other economies, including that of the United States, improve.

On the evidence presently available, it appears that most foreign central banks have opted for a cautious compromise somewhere in between the two principal alternatives. Interest rate reductions have, so far, been small, reflecting widespread uncertainty about future interest rate trends in the United States, prospects for further reductions in global inflation rates and the timing of economic recovery in the United States and elsewhere. Although the coming weeks will, no doubt, see further monetary policy easing and interest rate reductions abroad as the pressure for stepped-up economic growth increases, such moves will be cautious, tempered by the need to avoid reigniting inflation expectations. ■

Solar testing facility near Albuquerque, New Mexico.

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